

***United States Court of Appeals
for the Second Circuit***



**APPELLANT'S
REPLY BRIEF**

77-4143

B

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To be argued by
BURTON G. LIPSKY

In The
United States Court of Appeals
For The Second Circuit

MIRIAM SAKOL,
Petitioner-Appellant,

-against

COMMISSIONER OF INTERNAL REVENUE,
Respondent-Appellee.

Review of Decision of the United States Tax Court.

**REPLY BRIEF FOR
PETITIONER-APPELLANT**

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IN THE
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MIRIAM SAKOL,

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v.

COMMISSIONER OF INTERNAL REVENUE,

Respondent-Appellee.

Review of Decision of the United States Tax Court

REPLY BRIEF OF PETITIONER-APPELLANT

Miriam Sakol is appealing from the decision of the Tax Court on the ground that the court erred in holding that Section 83(a) of the Internal Revenue Code is constitutional even though that statute (a) mandates a fictitious valuation

of property in excess of its fair market value (thereby requiring petitioner to pay income tax on value not received), (b) precludes petitioner from proving the actual amount of income which she received, and (c) compels the taxation, as income, of an amount which is not income.

I

A STATUTE IMPOSING INCOME TAX BY MEANS
OF AN ARBITRARY CONCLUSIVE PRESUMPTION
THAT ADDS A FICTITIOUS AMOUNT TO INCOME
VIOLATES DUE PROCESS

The Supreme Court's holdings in Heiner v. Donnan, 285 U.S. 312 (1932), and Schlesinger v. Wisconsin, 270 U.S. 230 (1926), are dispositive of the due process violation of Section 83(a). A federal statute which imposes a tax based upon a fact "which...does not, and cannot be made to exist, in actuality..." and which the taxpayer is forbidden to controvert violates the Due Process Clause of the Fifth Amendment.^{1/} Notwithstanding the Supreme Court's recent approval of this rationale in Cleveland Bd. of Educ. v. LaFleur, 414 U.S. 632, 644 (1974); Vlandis v. Kline, 412 U.S. 441, 446 (1973); U.S. Dept. of Agriculture v. Murry, 413 U.S. 508, 512 (1973); and Stanley v. Illinois, 405 U.S.

^{1/} Heiner v. Donnan, 285 U.S. at 329.

645 (1972)^{2/}, the Commissioner dismisses this constitutional precept as not representing the "state of the law today" (Br. 10).

The Commissioner reaches his conclusion on a singular and misplaced reliance on Weinberger v. Salfi, 422 U.S. 749 (1975). Contrary to the Commissioner's interpretation, Justice Rehnquist did not reject the Donnan and

^{2/} For example, the Supreme Court stated in Vlandis v. Kline that (412 U.S. at 446):

"Statutes creating permanent irrebuttable presumptions have long been disfavored under the Due Process Clauses of the Fifth and Fourteenth Amendments. In Heiner v. Donnan, 285 U.S. 312, 52 S.Ct. 358, 76 L.Ed. 772 (1932), the Court was faced with a constitutional challenge to a federal statute that created a conclusive presumption that gifts made within two years prior to the donor's death were made in contemplation of death, thus requiring payment by his estate of a higher tax. In holding that this irrefutable assumption was so arbitrary and unreasonable as to deprive the taxpayer of his property without due process of law, the Court stated that it had 'held more than once that a statute creating a presumption which operates to deny a fair opportunity to rebut it violates the due process clause of the Fourteenth Amendment.' Id., at 329, 52 S.Ct., at 362. See, e.g., Schlesinger v. Wisconsin, 270 U.S. 230, 46 S.Ct. 260, 70 L.Ed. 557 (1926); Hoeper v. Tax Comm'n, 284 U.S. 206, 52 S.Ct. 120, 76 L.Ed. 248 (1931)."

Schlesinger rationale in Salfi. Instead, the Court was careful to distinguish two cases that followed that rationale (Stanley and LaFleur) on the ground that Salfi involved merely a claim for a non-contractual government benefit. The Court also distinguished Vlandis, which like Salfi did involve a government benefit program (in the form of reduced college tuition for in-state residents), on the ground that since the Connecticut statute tested its benefit by the factual question of residency, it could not at the same time deny to one seeking to meet the residency test the opportunity to show factors clearly bearing on that issue.

Neither Salfi distinction is applicable here. Section 83(a), like the Connecticut statute in Vlandis, makes one fact relevant on the measure of income - the fair market value of the restricted stock - and then excludes evidence of the substantial effect on fair market value of the restriction. Nor is there any support for the Commissioner in applying the minimum Salfi standard of due process review for government benefit programs to such burdens as deprivation of property through estate or income taxation.

The Commissioner treats (Br. 13) Salfi as rejecting the Donnan and Schlesinger rationale, rather than merely

presenting an exception to it, because of a reference in Justice Rehnquist's opinion that property rights are less important than the personal interests involved in Stanley and LaFleur (422 U.S. at 771). That reference in Salfi cannot be read as limiting an individual's right to a hearing to controvert an arbitrary irrebuttable presumption to statutes involving what the Commissioner labels as "non-property rights" (Br. 13). The Salfi opinion did not withdraw the Donnan and Schlesinger due process protection from legislative deprivations of property. Rather, the majority opinion in Salfi only limited judicial due process review to statutes "prescribing the conditions upon which funds shall be dispensed from the public treasury" or those "regulating the private sector of the economy" (422 U.S. at 774). Section 83 of the Internal Revenue Code cannot be characterized as falling within either category.

The Commissioner appears to find (Br. 14) support for his thesis that Donnan and Schlesinger no longer have validity in Usery v. Turner Elkhorn Mining Co., 428 U.S. 1 (1976). Here, again, he selects a few words in a Supreme Court opinion, out of context, and thereby claims that Turner is authority for the proposition that the limited Salfi standard applies to all statutes regulating economic matters. In Turner, the

Court upheld a statute "regulating the private sector of the economy" by providing benefits to coal miners suffering from "blacklung disease", and stated (428 U.S. at 23-24):

Since Congress can clearly draft a statute to accomplish precisely what it has accomplished through §411(c)(3)'s presumption of disability, the argument is essentially that Congress has accomplished its result in an impermissible manner - by defining eligibility in terms of "total disability" and enacting an "irrebuttable presumption" of total disability upon a factual showing that does not necessarily satisfy the statutory definition of total disability. But in a statute such as this, regulating purely economic matters, we do not think that Congress' choice of statutory language can invalidate the enactment when its operation and effect are clearly permissible. Cf. Weinberger v. Salfi....

The equation between statutes regulating economic matters in the private sector of the economy and an income tax statute does not exist. Nowhere in Salfi or Turner is there any indication, let alone a conclusion, that the due process review of a federal income tax statute would be judged under the Salfi standard.

It should also be noted that Justice Marshall,^{3/}

^{3/} Justice Marshall dissented in Salfi. He joined in the majority opinions in Stanley and LaFleur and concurred separately in Vlandis and Murry. Despite his obvious approval of the rationale of Donnan and Schlesinger, the Commissioner claims (Br. 11, 14) that the Turner decision confirms that Salfi has, in effect, overruled these earlier cases.

in his majority opinion (428 U.S. at 24) in Turner, distinguished Stanley and Vlandis on the ground that Congress could directly legislate for coal mine operators to provide benefits for miners suffering complicated pneumoconiosis and therefore that it chose to legislate by means of presuming compensable "total disability" by clinical evidence of complicated pneumoconiosis is not violative of due process. This distinction is not applicable here. Congress cannot directly legislate that an amount is "income" by labelling as income something which has no economic value or benefit. The Due Process Clause is violated when a statute puts upon a taxpayer "the burden of a tax measured in part by the value of property never owned by him...."^{4/} The Supreme Court has stated "that which is not in fact the taxpayer's income cannot be made such by calling it income"^{5/} and that statement represents the state of the law today whether or not an arbitrary conclusive presumption is employed as the means of inflating income.

^{4/} Heiner v. Donnan, 285 U.S. at 328.

^{5/} Hoeper v. Tax Commission, 284 U.S. 206, 215 (1931).

II

A LEGITIMATE LEGISLATIVE PURPOSE CANNOT REMEDY SECTION 83'S CONSTITUTIONAL INVALIDITY

The Commissioner defends the constitutionality of Section 83(a) on the ground that an area of income avoidance was discouraged by its enactment (Br. 21-25).^{6/} In Vlandis v. Kline, supra, the Supreme Court held a Connecticut statute unconstitutional which established a conclusive presumption of non-residence for the purpose of establishing tuition and other fees in the state university system. The Supreme Court ruled the legislative purpose legitimate (412 U.S. at 452-453):

We fully recognize that a state has a legitimate interest in protecting and preserving the quality of its colleges and universities and the right of its own bona fide residents to attend such institutions on a preferential tuition basis.

^{6/} The income tax avoidance potential detailed by the Commissioner (Br. 8-9, 21-22) resulted from his own regulations adopted in 1959. Regs. §1.421-6(d) provided that the measure of income at the time restrictions lapse would be the lesser of the restricted property's fair market value at the time of issuance or at the time the restriction lapsed. This regulation was not issued pursuant to any statute nor required by judicial doctrine. Clearly, amending the regulations to tax the appreciation as ordinary income (see Pet. Br., 8, 9, f.n.'s 5 and 7) or enacting a statute which denied an employer's deduction would also have eliminated the potential for income tax avoidance without denying due process to taxpayers.

But the court held (412 U.S. at 453) that the "means adopted by Connecticut to preserve that legitimate interest" -- the permanent irrebuttable presumption of non-residence -- violated the Due Process Clause. A legitimate legislative interest cannot be accomplished by unconstitutional means. Helvering v. City Bank Farmer's Trust Co., 296 U.S. 85 (1935). When Congress chose to accomplish its purpose by a statute which inflates petitioner's income for tax purposes, by adding a fictitious amount to fair market value, an unconstitutional means was employed -- regardless of the legitimacy of its purpose. It might be observed that Congress had constitutional alternatives available to achieve the same result.

In erroneously applying the limited Salafi standard to Section 83, the Commissioner's review of the background and operation of Section 83 is faulty in many respects. He criticizes (Br. 19) the statement contained in petitioner's brief that prior to the enactment of Section 83 all judicial and regulatory authority consistently provided that an employee's income on a bargain purchase of property is measured by the actual fair market value of the property. The Commissioner's example (Br. 19) does show that in his Regulation Sec. 1.421-6 it was possible for an employee's income to be equal to an amount less than fair market at the time of the taxable event. The Commissioner misses, however,

the basic point that until Section 83, an employee's income on a bargain purchase of property could never be an amount in excess of the fair market value of the property at the time of the taxable event.^{7/}

The Commissioner argues (Br. 19-20) illogically that petitioner's concession that it is not unconstitutional for her to be taxed on her actual economic benefit, when she receives it, even though that benefit cannot be realized (converted into cash on a sale), is somehow an acknowledgment that it is constitutionally permissible for her to be taxed on an amount in excess of the actual economic benefit received. In the case of compensation, it is the receipt of an actual economic benefit, not whether that economic benefit is immediately realizable that determines the timing of the income. See Commissioner v. LoBue, 351 U.S. 243 (1956); Commissioner v. Smith, 324 U.S. 177 (1945). But the constitution requires that the measure of this compensation income take into account the four-year restriction against sale.

Petitioner recognizes that in 1972 she realized a taxable economic benefit to the extent the fair market value of the restricted stock exceeded her cost. There was no

^{7/} See Pet. Br. 12.

economic benefit to the petitioner in 1972 to the extent of the difference between the New York Stock Exchange price of freely-traded shares and the fair market value of her restricted shares. It is taxing this fictitious amount, which Section 83(a) mandates is income in 1972, that violates petitioner's constitutional rights.

But the Commissioner argues (Br. 26) that paying income tax in 1972 on this fictitious amount does not violate her constitutional rights unless, in fact, her restricted stock declined in price over the four-year period. The New York Stock Exchange price for freely-traded Chesebrough shares did decline 8-1/2 points from May 7, 1972 to May 7, 1976. During that four-year period, the Chesebrough shares traded as low as \$26.75 on the New York Stock Exchange or 40 points below the Section 83(a) measuring price of her income (11a-12a, ¶6).^{8/} These actual price declines are immaterial, however, on the constitutional issue. What is material is that the petitioner in 1972 received property which could depreciate in value, a risk she could not eliminate until the restriction lapsed four years later. Despite the Commissioner's published position that such a restriction had a significant effect on value in

^{8/} Page numbers are references to the Appendix.

Rev. Rul. 68-86, 1968-1 C.B. 184, he now claims that no injury befell the petitioner in 1972 when she had to pay income tax on an amount which did not take this restriction into account.

The Commissioner suggests (Br. 27) that imposition of income tax on an amount that is not income in 1972 does not violate due process because any realized decline in the value of the stock may be an ordinary loss in 1976 or thereafter rather than a capital loss. Petitioner's constitutional rights were violated in 1972 when the income tax was illegally imposed on her. Possible symmetric tax treatment sometime in the future cannot cure that violation. In any event, it is frivolous for the Commissioner to suggest ordinary loss treatment on brief when it is so clear that any loss realized by petitioner would be characterized as a capital loss and his own proposed regulations under Section 83 confirm capital loss treatment.^{9/}

The administrative burden of individual hearings on the valuation of restricted stock is stressed (Br. 23-25) by the Commissioner who speculates that Congress considered such administrative inconvenience when it enacted the Section 83(a) valuation rule. Administrative convenience was never advanced by the Congress or the Treasury as a reason for the valuation rule of Section

^{9/} Proposed Treas. Reg. §1.83-1(b). 36 Fed. Reg. 10787 (1971).

83(a). The valuation problem exists only because Congress determined in Section 83 that the taxable event in a bargain purchase of nonforfeitable restricted stock is the purchase date and not when the restriction lapses. Having made that determination, the Constitution permits income to be measured only by the actual fair market value of the restricted stock on the date of the taxable event. If the elimination of deferral by Section 83 cannot be administered without disregarding restrictions which have a significant effect on value, the remedy is not to deprive petitioner of her constitutional right to a hearing on the fair market value of her restricted property, but to amend the statute.^{10/}

The Section 83(a) valuation rule is not justifiable because petitioner purchased the restricted shares of her "own volition" with knowledge of the unfavorable tax consequences provided by the statute.^{11/} By accepting

^{10/} Restricted stock plans could have been discouraged and individual hearings avoided by measuring gross income by the fair market value at the date of the lapse of the restrictions. Valuation problems are avoided with respect to stock options, without a readily ascertainable fair market value, by not taxing the employee at the date of grant. Regs. §1.421-6(d)(1) (1959); Commissioner v. LoBue, 351 U.S. 243 (1956); Commissioner v. Smith, 324 U.S. 177 (1945).

^{11/} Comm. Br. 24.

the only economic benefit offered to her in the form of her employer's stock, petitioner did not agree to be taxed as if she had received something in addition. Her conduct did not constitute a waiver of her constitutional rights or a consent to the financial hardship imposed by the statute. The Commissioner's argument that petitioner's conduct was "voluntary" and somehow renders Section 83 constitutional as applied to her, is another "new and startling doctrine, condemned by its mere statement".^{12/}

III

SECTION 83(a) IS AN UNAPPORTIONED DIRECT TAX AGAINST PETITIONER'S RESTRICTED PROPERTY

In her opening brief (13-14) the petitioner accurately described the function of the Sixteenth Amendment to provide an exception for taxes on income to the constitutional qualification on the broad taxing power of Congress that direct taxes be apportioned. See Penn Mutual Indemnity Co. v. Commissioner, 32 T.C. 653 (1959). To the extent the petitioner's Chesebrough shares are not income, the tax on such shares imposed by Section 83 is a direct tax on the property itself. Eisner v. Macomber, 232 U.S. 189, 205

^{12/} Heiner v. Donnan, 285 U.S. at 328.

(1920), citing Pollock v. Farmer's Loan & Trust Co., 158 U.S. 601 (1894).

The Commissioner argues (Br. 29) that the tax is not a direct tax since it was a tax "on the receipt by her of value" which "constitutes a tax on the receipt of compensation for services". The Commissioner thus decides the question by assuming the answer. To the extent the petitioner has received no economic benefit upon the receipt of the restricted property, such property does not constitute compensation for services, i.e., income. If the amount added to the fair market value of her restricted property (excess of the New York Stock Exchange price over fair market value) is of no value to her, then a tax on such an amount is a direct tax on the property itself. Congress may not lay an unapportioned direct tax against petitioner's property and here the Sixteenth Amendment is no exception to the apportionment limitation to the extent such property is not income to petitioner.

Respectfully submitted,

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November, 1977

APP
COURT OF APPEALS
SECOND CIRCUIT

Index No.

MIRIAM SAKOL,

Petitioner-Appellant,

- against -

COMMISSIONER OF INTERNAL REVENUE,
Respondent-Appellee.

Affidavit of Service by Mail

STATE OF NEW YORK, COUNTY OF NEW YORK ss.:

I, Robert L. Martinez, being duly sworn, depose and say that deponent is not a party to the action, is over 18 years of age and resides at 1165 Morris Avenue; Bronx, New York; 10456 That on the 28th day of Nov. 1977, deponent served the annexed

Reply Brief

upon M. Carr Ferguson

attorney(s) for

Asst Attorney General

in this action, at Washington D. C.

the address designated by said attorney(s) for that purpose by depositing a true copy of same, enclosed in a postpaid properly addressed wrapper in a Post Office Official Depository under the exclusive care and custody of the United States Post Office Department, within the State of New York.

Sworn to before me, this 28th
day of November, 19 77

Robert L. Martinez

ROBERT T. BRIN
NOTARY PUBLIC, State of New York
No. 31-0418950
Qualified in New York County
Commission Expires March 30, 1979

